Canterbury Outsourced CIO

First Quarter 2021 Commentary

Overview

As the first quarter of 2021 progressed, governments across countries made a concerted effort to move toward some semblance of normality. A decline in new COVID cases, vaccine availability, and the continued commitment by central governments to maintain accommodative policies have all contributed to improved economic activity, albeit at a very different pace in various regions.

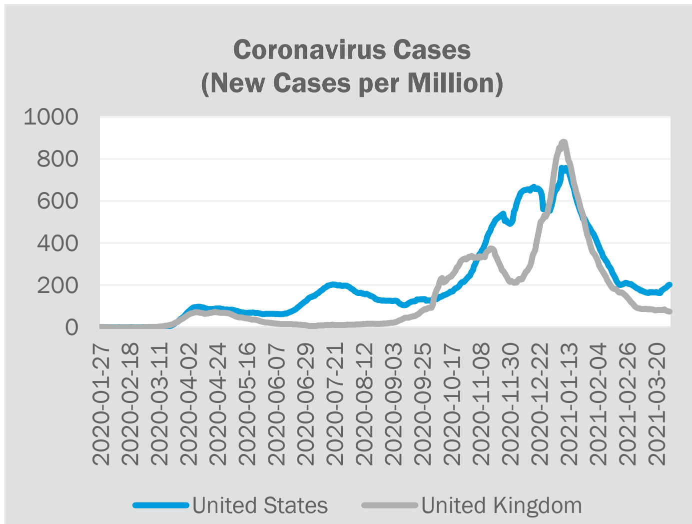


Figure 1. Source: Worldometer's COVID-19 data as of March 25, 2021.

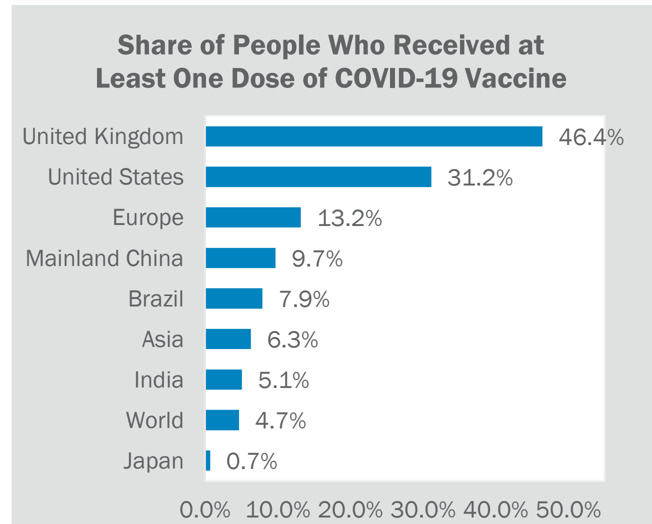


Figure 2. Source: Vaccination data from Oxford University as of April 5, 2021.

Among the larger countries, the UK and the U.S. lead in vaccine doses administered, while many other countries with large segments of the world population still seem to be working through political or logistic issues. As seen in upticks of new cases in France, Germany, and even in the U.S., there is a healthy dose of caution over the potential upsurge in virus variants. Any acceleration in the number of cases could slow down the reopening process.

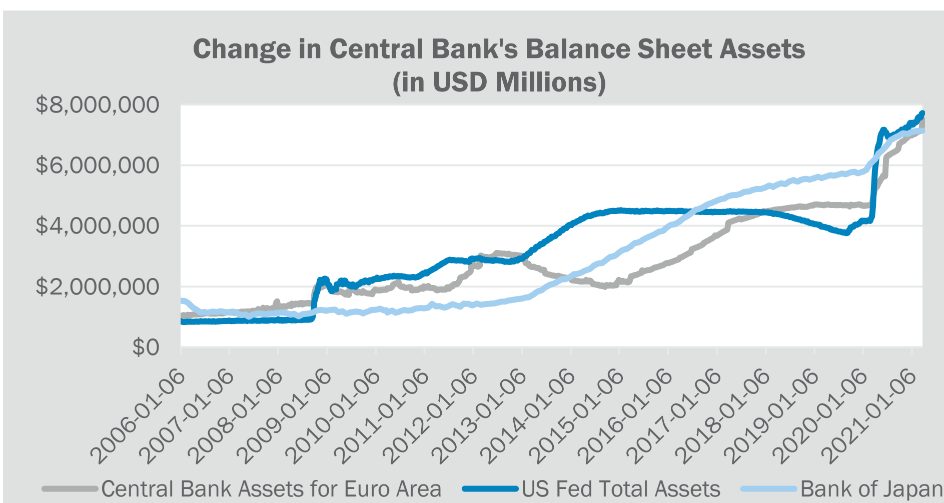


Figure 3. Source: St. Louis Federal Reserve as of March 31, 2021.

Over the past year, central banks have injected trillions into their respective economies to combat recessionary pressures from the lockdowns. These stimulative policies and pent-up savings from the past year will cause economic activity to pick up as lockdowns unwind. The question seems to be around timing. In the first quarter, the Biden administration announced

fiscal and infrastructure spending in the U.S. that would exceed another $4 trillion.

In the wake of upward revision in growth forecasts, the federal government's commitment to low rates and quantitative easing (QE) have contributed to rising inflation expectations. In the U.S., as much of this stimulus money has reached the hands of consumers, it has found its way into the economy. Unlike the QE efforts post the 2008 global financial crisis, this time, we have seen a dramatic impact of the stimulus, which has caused the M2 money supply to jump sharply since the onset of the 2020 stimulus packages.

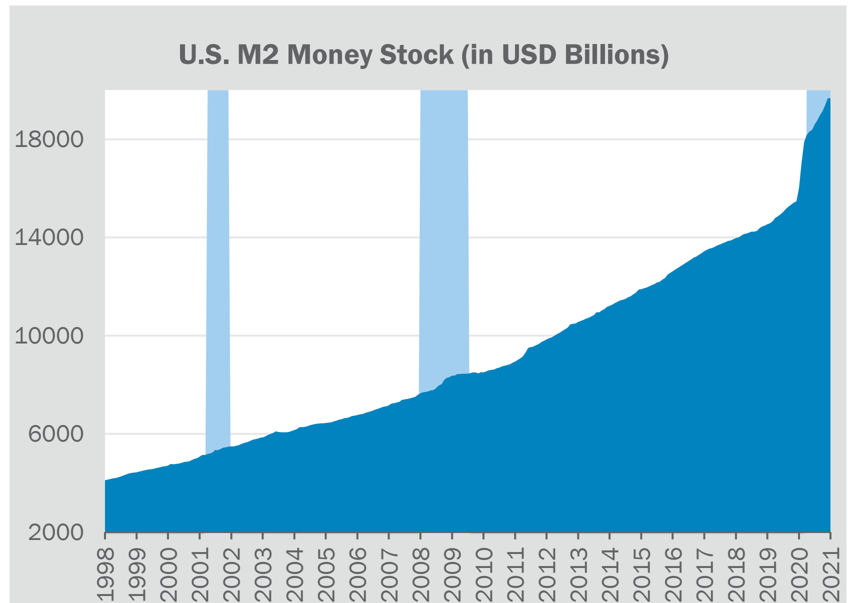


Figure 4. Source: St. Louis Federal Reserve as of March 31, 2021. Light blue areas are indicative of recession periods.

As a result, rates have moved up along the yield curve and the Fed has combated this rise with open market asset purchases of Treasurys, mortgage-backed securities, and corporate bonds. The same dynamics have played out across major economies. Through March 2021, the U.S. Federal Reserve, the Bank of Japan, and the European Central bank have grown their balance sheet assets to over $7 trillion each.

The strong performance of the equity markets reflects that the financial markets may have discounted much of these near-term dynamics around the unwinding of the lockdowns. Where uncertainties remain is whether the tilt over time is likely to be around growth and inflation, or whether the uneven recoveries open roads further to economic divergence and the potential stagnation.

We have incorporated a number of changes within our client's portfolios over the last year, including a few manager changes where we believed their portfolio's performance pattern was drifting outside of our range of expectations. Further, we made a tilt towards a higher allocation to equities, specifically after the equity market drawdown in March 2020. We felt that the near-zero interest rate environment made fixed income particularly less attractive from a return perspective and also in anticipation of headwinds faced by the sector as interest rates inched up.

The high levels of sovereign debt held on the balance sheet of the G7 countries may be a drag on global growth, but equities remain more attractive from a return potential and as a natural hedge to higher inflation over time. We have maintained a neutral exposure to the U.S. equity markets relative to the global equity indexes but continue to watch closely the development of both emerging and emerged economies and seek to have exposure to those areas that are attractively valued given their growth potential.

Equities

Since the announcement of the availability of vaccines last November, we have observed a fairly sustained appreciation of stocks that had lagged during the pandemic-induced lockdown. Their appreciation is reflective of the markets anticipating a broad-based recovery in the U.S. and globally. These securities represent industries such as Travel, Real Estate, Construction & Engineering as well as Financial and Energy companies that are positioned to benefit from increased mobility and economic activity.

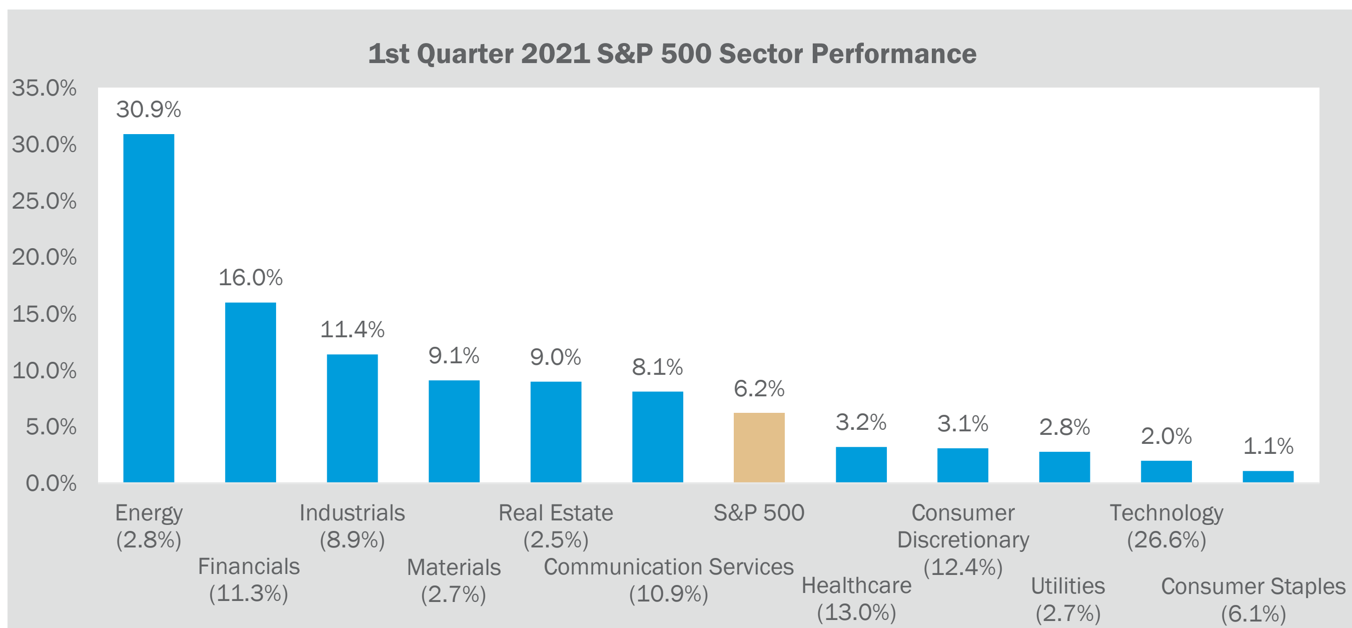


Figure 5. Source: Standard & Poor's as of March 31, 2021.

The healthy return for the S&P 500 Index of 6.2% for the first quarter was driven by the strong performance of sectors such as Energy, Financials, Industrials, and Materials. In a dramatic rotation from the first three quarters of 2020, small-cap and value-oriented stocks have outperformed their growth counterparts over the last 5 months. For the first quarter of 2021, U.S. small-cap value stocks were ahead of their large-cap growth peers by over 2000 basis points. A similar pattern of performance was apparent in non-U.S. markets as well, with value-oriented segments outperforming the growth segments and a decline in the U.S. Dollar relative to other currencies, leading to non-U.S. stocks performing better in U.S. Dollar terms relative to their returns in local currency.

The OCIO portfolios are balanced across market capitalization and size. Throughout the year, we have taken opportunities with cash flow to reallocate to those segments that lagged last year, thus having targeted exposure as those segments appreciated. The broadening out of market performance has also been a positive for active management in the U.S. equity segment, as we have seen the active managers contribute positively over the broad market indices for the quarter.

1st Quarter 2021 Returns

	Value	Blend	Growth
Large	11.3%	6.2%	0.9%
Mid	13.1%	8.1%	-0.6%
Small	21.2%	12.7%	4.9%

Figure 6. Source: FTSE Russell as of March 31, 2021.

Fixed Income

Where the "good news" about potential improving economic activity has been a positive for equity markets, the fixed income markets have responded with expectations for rising inflation. The yield curve steepened during the quarter, with intermediate and long yields rising close to 80 bps. Overall, rates remain very low and accommodative, but we have seen the 10-year go from a low of 0.52% in early August 2020 to 1.74% at the end of March. The Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index returned -3.4% and -4.5% respectively for the quarter.

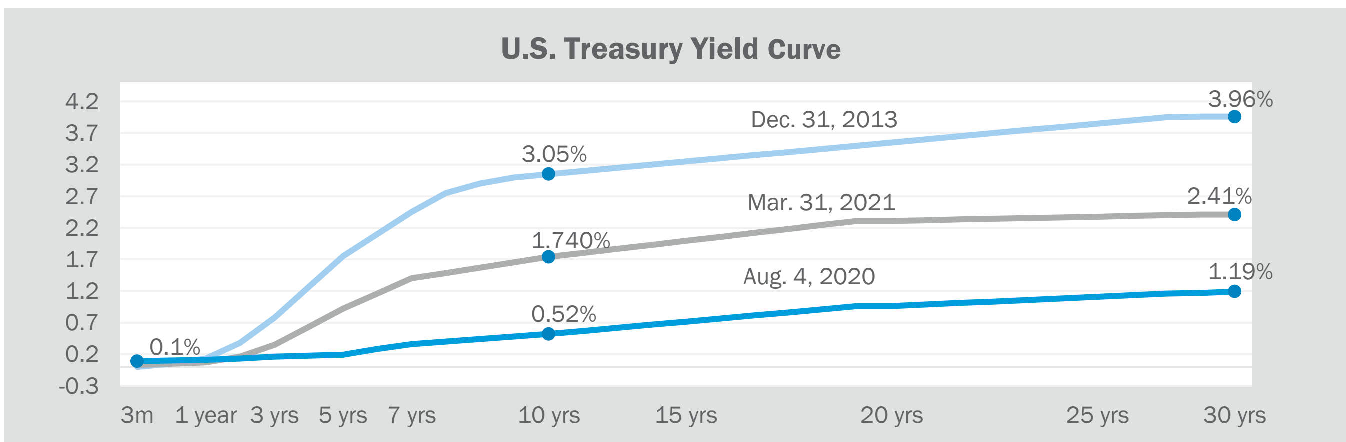


Figure 7. Source: U.S. Treasury as of March 31, 2021.

Our portfolios have been conservatively positioned to be short in duration relative to the benchmarks for many years now, specifically to protect against a rising rate environment. The portfolio has also benefited from active managers that have been able to move around sectors to avoid overvalued areas, such as Treasurys, and add to undervalued segments and securities to pick up yield. We continue to hold fixed income for its defensive qualities during periods of equity market volatility, but also recognize that the low yields provide very little income cushion to protect against negative returns when rates go up.

If the uncertainties around longer-term global growth keep interest rates range-bound over time, we will continue to maintain a diverse and cautious approach.

Hedge Funds

We have historically invested with hedge funds that demonstrate the ability to employ a wider range of tools in the equity and credit marketplace. They can both hold individual securities with the potential to appreciate as well as short those that they feel have fundamental reasons to decline in value. The GameStop phenomenon in January of this year proved how certain large hedge funds can be targeted by a concerted effort across a group of retail investors and be forced to realize large losses from just a few positions.

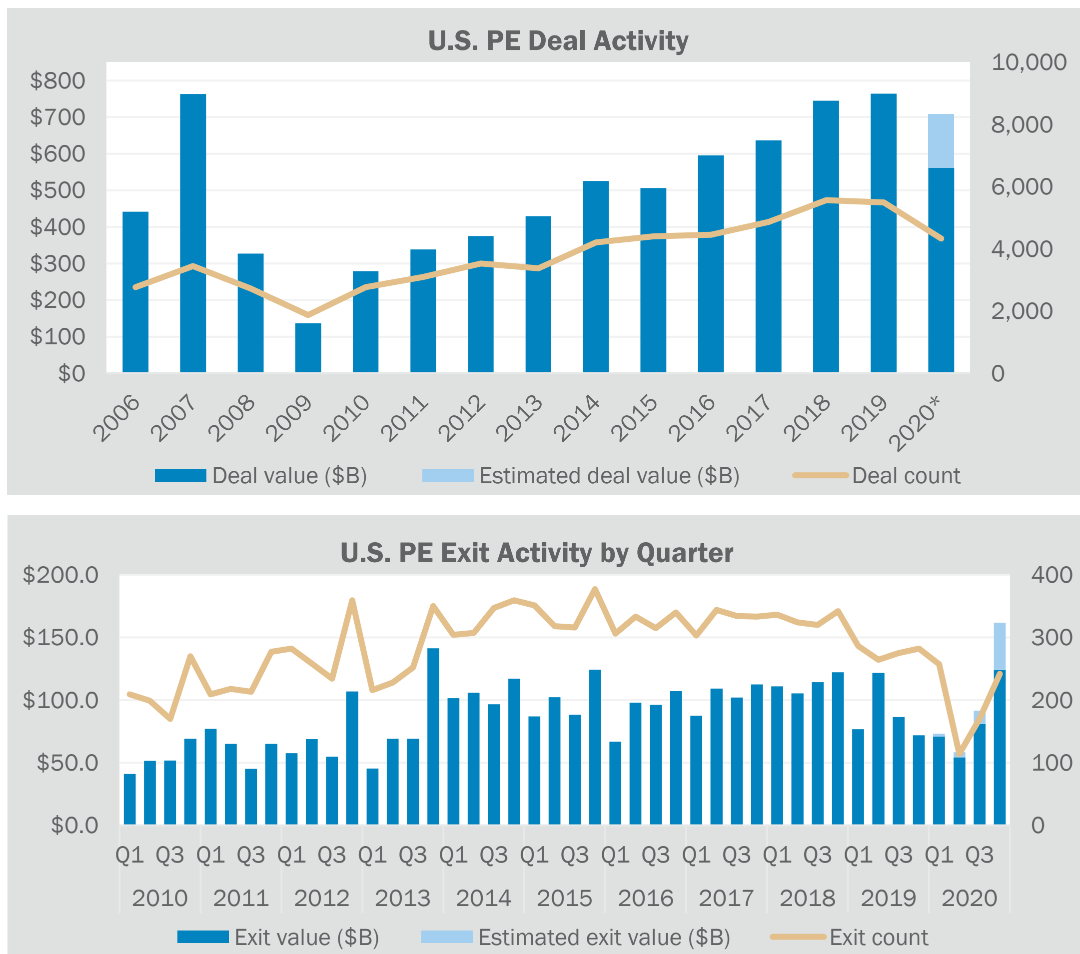
The effect is particularly acute on funds that use a high level of leverage and tend to be very public with their holdings, particularly their short positions, which they are betting will go down. Risk management is of primary concern with the funds. Our preference has been to invest with managers that are skilled and rely on security selection rather than leverage to generate returns. The wave of mergers and spinoffs generated by industry evolutions and the impact of the pandemic have provided both credit and equity opportunities on the long and short sides.

Real Assets

The prospects for reopening as well as concerns over inflation had a strong positive impact on the value of hard assets, particularly commodities and energy assets. The segment is exposed to real assets as well as interest-rate-sensitive assets that generated positive gains for the quarter and the year. The investment is through a fund where the manager can tilt allocations based on their assessment of inflationary pressures as well as the relative opportunity across the segments.

Private Equity

Where the global pandemic induced a year-long lockdown, the equity market correction was perhaps one of the shortest on record. Private equity activity paused during the second quarter of 2020 but picked back up as public markets rebounded and fund managers began to take advantage of price declines in March 2020. The yearend activity report for 2020 shows that both from the perspective of PE deal activity as well as PE exits, their activities matched the trend from prior years. The total deal count was lower due to a lull in the mid-year, but quarterly measures reached robust levels in the fourth quarter.



Figures 8 & 9. Source: PitchBook as of December 31, 2020.

Our research on private equity performance over the years has shown that fund IRRs tend to smooth out over market cycles, as private equity managers can take advantage of market dips to accelerate purchases and use strong markets to look for exit opportunities.

We have stayed consistent with our pace of PE commitment over the years, as the investments have long lives and there is greater risk of not achieving the consistent long-term returns by trying to time the allocations. In this low-rate, low-growth environment, we continue to believe that private equity can provide a way to add incrementally to returns over public markets. For institutions that can take some level of illiquidity, this is one way to get closer to meeting long-term spending needs.

Environmental, Social, and Governance

We are seeing an increase in the number of clients looking to explore the application of ESG filters in their investments. Whether it is to reflect their organization's values in their portfolio or to identify companies that have better business practices than their peers, there is greater availability of information on companies that managers can sift through to add to their assessment of the underlying investment opportunity. While certain organizations may already have honed in on specific impact investment strategies or screens that they would like to employ, others may still be at a stage where they are figuring out which filter would be appropriate given their mission. Having helped a number of clients discover and implement ESG processes, we welcome our client's interest in this space.

Overall Thoughts

Our approach is to remain thoughtful about the changing landscapes of the many economies and market dynamics. We are always exploring new opportunities and ideas, but we are selective, making deliberate decisions that can be both meaningful and sustainable given each of our client's unique needs.

Most portfolios have recovered from the market losses faced earlier in the year and have appreciated further from that point. Neither stocks nor bonds seem cheap. At 22x forward earnings, the S&P 500 has an earnings yield of 4.5%, which is more attractive than the U.S. 10-year Treasury, which is yielding under 2% and comparable to core real estate cap rates. However, the upside potential seems limited from these levels.

Our current focus is looking at future expectations from where we are today, and determining how to best help our clients meet their long-term return growth objectives. While manager selection is an important element, we feel this may also trigger a discussion of the overall strategic allocation framework. We look forward to discussing this with our clients in person as we meet, albeit virtually, over the upcoming quarters.

We remain at your service.

Sincerely,

Poorvi, R. Parekh, CFA
Director of Outsourced Investments

Ms. Parekh is a member of the Board of Directors, a shareholder of Canterbury, and directs the Canterbury Outsourced CIO platform, which caters to institutions and private clients seeking to outsource the day-to-day management of their portfolios. In this role, Ms. Parekh is the chair of the Canterbury Outsourced CIO Committee and a member of each of the firm's five Manager Research Committees. Joining Canterbury in 1996 as the manager of analytics, she directed the firm's account analysts and client services group, securing many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research — responsible for oversight of all manager, fund, and product research; maintenance of Canterbury's proprietary research database; and chairing the Investment Manager Research Committee. Ms. Parekh graduated from the University of Hong Kong with a Bachelor of Arts in economics and completed her Master of Business Administration at Shenandoah University.

About Canterbury

Canterbury Consulting is an independent investment advisory firm based in Newport Beach, CA. Canterbury provides consulting services to tax-exempt organizations, including community foundations, educational endowments, religious organizations, arts and cultural foundations and health care organizations, as well as individuals and family offices. Founded in 1988, the firm designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement.

Named one of the Best Places to Work in Money Management by Pensions & Investments and one of the Best Places to Work in Orange County by the Orange County Business Journal in 2020, Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients. Learn more about Canterbury at www.canterburyconsulting.com.